BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GEORGE E. GORDON, JR.)

Appearances:

For Appellant: Hillel S. Aronson
Certified Public Accountant

For Respondent: Gary Paul Kane
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of George E. Gordon, Jr., against a proposed assessment of additional personal income tax in the amount of $1,695.21 for the year 1961.

One question for decision is to what extent appellant is liable for tax on the 1961 income derived from the operation of the Gordon Sand Company. The second question is whether a $9,500 payment made by appellant in 1961 constituted a deductible expense or a nondeductible capital expenditure.

Appellant and Kathryn H. Erickson, formerly Kathryn Gordon, separated in 1961. It was provided in a property settlement agreement dated July 24, 1961, that prior to their marriage in 1946 neither party owned any separate property of material value, nor acquired any separate property thereafter.

The agreement provided for the transfer of certain community properties to Mrs. Erickson as her separate properties and for $500 per month support payments. However, it provided that the Gordon Sand Company, an unincorporated business which was community property, would thereafter be the sole and separate property of appellant. It also provided that all earnings and income of any nature thereafter acquired by either party from

any source would constitute separate property. In accordance with the agreement, appellant appropriated all the income derived from the operation of the Gordon Sand Company to his own personal use and made the agreed support payments.

The divorce action was tried October 15, 1962, through October 26, 1962, and Mrs. Erickson was awarded an interlocutory judgment of divorce.

Paragraph IV of the court's Findings of Fact provided, in part:

> That plaintiff and defendant, by and through their respective counsel, have stipulated that the purported property agreement dated July 24,1961,... shall be considered null and void and of no legal force or consequence whatsoever.

In accordance with the stipulation, the court found that the assets of the Gordon Sand Company were community property and awarded one-half of the company to Mrs. Erickson as her sole and separate property and one-half to appellant as his sole and separate property. Other described properties were awarded to Mrs. Erickson as her separate properties. Appellant'was to pay $350 monthly for child maintenance.

It appears that subsequent to the trial the business went into receivership. Mrs. Erickson ultimately purchased appellant's interest.

In 1961 appellant reported all of the income from the Gordon Sand Company as his separate income. Mrs. Erickson did not report any of this income in 1961.

Respondent disallowed certain deductions and, on the theory that all income from the business was community income, increased the reported income of each spouse by one-half of the disallowed deductions. Consistent with this theory, the amount originally reported by appellant should also have been apportioned by respondent. Through inadvertence, however, respondent did not make this adjustment.

Appellant contends that the express findings of the court establish that the applicable provisions in the 1961 property agreement were void from the very beginning and that all the 1961 income derived from the investment in the business and from appellant's services was therefore community income. He asserts that he reported all the income on his separate return as separate income only because of unfamiliarity

with the community property laws and because prior to 1961 he had been filing joint returns with his wife. He further asserts that certain credits ultimately given Kathryn prior to the sale of the business to her, evidence the continuing community property nature of the business.

We first conclude that the Gordon Sand Company was community property until July 24, 1961. The property agreement provided that prior to marriage neither party owned any property of material value and that subsequent to their marriage, neither party had acquired any separate property. No evidence was introduced of any agreement converting the status of this property from community to separate property until July 24, 1961.

We also conclude, however, that the income of appellant pertaining to the Gordon Sand Company for the balance of 1961 was taxable entirely to appellant as his separate income. Pursuant to the July 24, 1961 agreement, income from the company was entirely appellant's income. The parties were entirely free to change the character of the existing community property and of future earnings to be derived from appellant's services. (Helvering v. Hickman, 70 F.2d 985; Van Dyke v. Commissioner, 120 F.2d 945.) However, it is also a well established rule that while each member of the community has the power to dispose of past, present or future income to the other, neither has the power to transfer the incidence of tax as to earnings of the community already existing at the time of the transfer. (Johnson v. United States, 135 F.2d 125; Ione C. Hubner, 28 T.C. 1150.) The same logic applies to efforts to convert past separate income to community income. Accordingly, for tax purposes, the 1962 stipulation should not be regarded as converting appellant's separate income to community income for the period July 24, 1961, to October 26, 1962.

With respect to the second issue, appellant and his former wife entered into a written agreement on October 7, 1960, providing for the purchase of certain assets from the Paramount Sand Company. The contract provided under the heading "CONSIDERATION" that

> Buyers will pay to Sellers . . . the 'following amounts:
>
> (a) For good will, customers lists and the right to use said telephone number, the sum of Five Hundred Dollars ($500.00).
>
> (b) The sum of Nine Thousand Five Hundred Dollars ($9,500.00)....

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A $9,500 check was issued by appellant to the Paramount Sand Company January 2, 1961. The face of the check recites that the payment was "As per paragraph II (B) of agreement dated Oct. 7,1960 Consulting Services, Mr. Charles Settle (Research & Development)."

Respondent disallowed the $9,500 business expense deduction.

Appellant contends that the deduction should have been allowed, claiming that there was a supplementary oral agreement with the seller designating the $9,500 as a payment for personal services. Appellant also asserts that there was an oral agreement with Mr. Charles R. Settle, the seller, that he would treat the payment as ordinary income although no proof was offered that Mr. Settle did report the payment in this manner. The burden of proving facts sufficient to substantiate claimed deductions is upon the appellant. (New Colonial Ice Co. v. Helvering, 292 U.S. 435[78 L. Ed. 1348].) The language on the check appears to be contradicted by the provisions of the purchase agreement indicating that the $9,500 payment was part of the consideration paid for assets of the Paramount Sand Company. Accordingly, no concrete evidence has been introduced supporting the view that the payment was other than a non-deductible capital expenditure.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of George E. Gordon, Jr., against a proposed assessment of additional personal income tax in the amount of $1,695.21 for the year 1961 be and the same is hereby sustained..

Done at Sacramento, California, this 19th day of November, 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary